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IN THE

Supreme Court of the United States

OCTOBER TERM, 1996

TAXATION AND REVENUE DEPARTMENT
OF THE STATE OF NEW MEXICO,

Petitioner,

v.

CONOCO INC., AND INTEL CORPORATION,

Respondents.

ON PETITION FOR CERTIORARI TO THE
SUPREME COURT OF THE STATE OF NEW MEXICO

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Can New Mexico tax approximately 75% of dividends flowing in foreign commerce (it excludes 25% by including a portion of the factors of the foreign dividend payors in the apportionment formula), when it exempts dividends flowing in domestic commerce entirely, without discriminating against foreign commerce in violation of the Foreign Commerce Clause and this Court's decision in *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*, 505 U.S. 71 (1992)?

LIST OF PARTIES

The parties to the proceeding below were the same as those mentioned in the present caption.

In the proceeding below, and in the Petition for a Writ of Certiorari, Conoco Inc. is referred to as Conoco, Inc. The corporation's actual name is Conoco Inc. and is so referred to herein.

RULE 29.6 STATEMENT

Respondent Conoco Inc., a Delaware corporation, is a wholly owned subsidiary of Du Pont Energy Company, a Delaware corporation, which is in turn owned 99.8 percent by E.I. du Pont de Nemours and Company, a Delaware corporation. The following are nonwholly owned subsidiaries of Respondent Conoco Inc.:

- Big Sky of Montana Realty, Inc.
- Cit-Con Oil Corporation
- Conch International Methane Limited
- Conoco, A.G.
  - Du Pont Conoco Nordic AB
  - Danube Insurance Ltd.
    - Conoco Arabia Ltd.
    - Conoco Iraq Ltd.
    - Conoco Oriente Ltd.
    - Conoco Peru Ltd.
    - Whitebridge Ltd.
    - Conoco Venezuela Ltd.
    - Conoco Mexico Ltd.
    - Conoco Barbados Ltd.
    - Conoco NW Natuna Exploration and Production Ltd.
    - Conoco Khazar Ltd.
  - OK Coop A.G.
  - Societa Italiana Per L'Oleodotto Transalpino S.p.A.
  - Transalpine Oelleitung in Oesterreich Gesellschaft M.B.H.
  - Gemeinnutzige Wohnungsbaugesellschaft GmbH
  - Conoco Arabia Ltd.
  - Conoco Iraq Ltd.
  - Conoco Khazar Ltd.
  - Conoco Mexico Ltd.
  - Conoco Mineraloel GmbH
    - Deutsche Transalpine Oelleitung GmbH (T.A.L.)
    - Etzel Gas Lager Project
    - Societue du Pipeline Sud-Europeeno S.A.
    - GKG Mineraloelhandel Gmbh & Co. KG
    - Zeller & Cie SARL
    - GKG Mineraloelhandel Handel Verwaltungsgesellschaft mbH
    - Gebinde-Vertungsgesellschaft der Mineraloelwirtschaft mbH
  - Conoco Norway Inc.
    - K/S Statfjord Transport A.S. & CO.

- Statfjord Transport A.S.
- Statoil Metanol A/S
- Tjeldbergodden Luftgassfabrikk DA
- Conoco Oriente Ltd.
- Conoco Peru Ltd.
- Conoco Pipe Line Company
  - Colonial Pipeline Company
  - Dixie Pipeline Company
  - Explorer Pipeline Company
  - Lake Charles Pipe Line Company
  - Pioneer Investments Corp.
    - Pioneer Pipe Line Company
    - Salt Lake Terminal Co.
  - Yellowstone Pipe Line Company
- Conoco Timan-Pechora Ltd.
  - Polar Lights Company
- Conoco Venezuela Ltd.
- Cure Inc.
- Du Pont Energy Company
- Felix Oil Company
- Jupiter Holding, Inc.
  - Jupiter Chemicals, Inc.
  - Jupiter Sulphur, Inc.
- Kayo Oil Company
  - Fas-Gas Retail Services Co. of Texas
  - Sentinel Concessions, Inc.
- Kettleman North Dome Association
- Marine Preservation Association
- Oberrheinische Mineraloelwerke GmbH (OMW)
  - Mineraloelraffinerrie Oberrhein GmbH & Co. KG
- Mineraloelraffinerrie Oberrhein Verwaltungs GmbH
- Petco Enterprises Ltd.
- Petrocokes, Ltd.
- Phoenix Park Gas Processors, Ltd.
- San Jacinto Eastern Corporation
  - Iranian Investment Corporation
  - Iranian Oil Participants Limited
  - Iranian Oil Services (Holding) Limited
- Siam Conoco Land Ltd.
- Siam Conoco Terminal Co. Ltd.
- The Standard Shale Products Company
- Tidelands Royalty Trust

Respondent Intel Corporation is a publicly held corporation with no parent companies and no nonwholly owned subsidiaries.

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The Respondents, Conoco Inc. and Intel Corporation, respectfully request that this Court deny the petition for a writ of certiorari, seeking review of the Supreme Court of the State of New Mexico's opinion in this case.

STATEMENT OF THE CASE

A. The Facts

1. The *Kraft* Decision

In June, 1992, this Court held in *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*, 505 U.S. 71 (1992), that Iowa's corporate income tax scheme facially discriminated against foreign commerce in violation of the Foreign Commerce Clause of the United States Constitution. That was so because Iowa's corporate tax base, just like New Mexico's, included dividends received in foreign commerce, but not dividends received in domestic commerce.

In November, 1996, and again in January, 1997, after denying the Petitioner's Motion for Reconsideration, the New Mexico Supreme Court applied *Kraft* in this case and held that New Mexico's corporate income tax scheme similarly violates the Foreign Commerce Clause.

The source of this disparate treatment of dividend income is the federal definition of taxable income used by most states as their income tax base. Although the majority of states use federal taxable income as their income tax base, only a few states, such as Iowa, New Mexico and Rhode Island, do not by statute eliminate the resulting disparity between the tax treatment of dividends flowing in foreign commerce and dividends flowing in domestic commerce.

The decision in *Kraft* initiated a series of events in New Mexico which culminated in the instant matters. At the heart of these matters is the thinly veiled attempt by the Taxation and Revenue Department of the State of New Mexico (the "Department") to circumvent *Kraft* by using factor representation to tax about 75% of a company's foreign dividends.

2. The Refund Claims and the Department's Response

Conoco Inc. ("Conoco") and Intel Corporation ("Intel") filed their New Mexico tax returns for 1988 to 1991, inclusive, using the separate entity reporting method. In the fall and early winter of 1992, in reliance on *Kraft*, Conoco and Intel (together, "Respondents") filed their respective original tax returns for 1991, and their respective amended returns for 1988 through 1990. The amended returns sought refunds of overpaid taxes and, in accordance with *Kraft*, excluded foreign dividends from the New Mexico tax base in the same manner as all corporations were authorized to exclude domestic dividends from the New Mexico tax base. The 1991 returns similarly excluded foreign dividends from the New Mexico tax base.

In February, 1993, eight months after *Kraft* was decided law, the Department denied Conoco's refund claims for 1988 through 1990 and issued to Conoco a corporate income tax assessment for 1991 which imposed tax on the company's foreign dividend income while not imposing tax on its domestic dividend income. The Department similarly denied Intel's refund claims for 1988 through 1990, and denied the portion of Intel's refund claim for 1991 that was attributable to Intel's exclusion of foreign dividends.[1]

The Department advanced three theories for its prompt actions. First, the Department asserted that *Kraft* should be given "prospective application only." Thus, relying on the doctrine of selective prospectivity, the Department argued that corporate taxpayers were not entitled to any relief with respect to the taxes they had overpaid as a result of New Mexico's unconstitutional scheme for taxing dividend income.[2]

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[1] The Department did not issue an assessment to Intel for 1991, as it did to Conoco, because Intel had overpaid estimated taxes for that year.

[2] In its denial letters to Intel, the Department asserted that its separate entity reporting method with respect to the taxation of domestic and foreign

(Footnote continued)

The Department's second theory for denying relief was premised on its contention that New Mexico's method of dividend taxation in the context of combined and federal consolidated reporting was constitutional. According to the Department, *Kraft* applied only to those corporate taxpayers that used the separate entity reporting method and since, under New Mexico's scheme of corporate income tax reporting, corporations could have elected to use combined or federal consolidated reporting, they presumably had a constitutional reporting method available. Therefore, the Department's argument went, such taxpayers were not harmed by the constitutional infirmities of separate entity reporting -- any harm was purportedly a problem of the taxpayer's own making by not electing to have its income taxed in another manner.

Although limited in applicability, the Department also advanced a third theory for not refunding the unconstitutionally collected taxes. The Department contended that *Kraft* was inapplicable to deemed dividends (such as federal Subpart F income). Under this theory, *Kraft* only applied to actual repatriated foreign dividend income.

3. The Department's Response to *Kraft*

In late 1992, prior to formally denying Respondents' refund claims and asserting an assessment against Conoco, the Department was revising its corporate income tax instructions for 1992. For the 1992 tax year, the Department ordered separate entity taxpayers to exclude foreign dividend income just as domestic dividend income was excluded.[3] *Thus, for 1992,*

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dividends was constitutional and that, in any event, the *Kraft* decision "should be given prospective application only."

[3] The instructions provided that:

> The Iowa statute struck down by the U.S. Supreme Court [in *Kraft*] is substantially similar to the separate entity method of reporting allowed as an option by New Mexico's corporate income tax statutes and may be applicable to New Mexico taxpayers filing under that method of reporting. In order to ensure that New Mexico's corporate income taxes are

(Footnote continued)

the Department adopted the same method to remedy the unconstitutional discrimination that Conoco and Intel were claiming for prior years.

The Department was also keeping the New Mexico Legislature informed of its activities. In late 1992 and early 1993, the Department repeatedly submitted written reports stating that it thought *Kraft* was applicable to New Mexico's scheme for taxing dividend income of separate entity corporate taxpayers. In February, 1993, only days after the denial letters were mailed to Respondents, the Department made public pronouncements and explained to the New Mexico Legislature that "*Kraft v. Iowa* makes it clear that the New Mexico 'separate entity' option is unconstitutional as written." Bill Analysis and Fiscal Impact Report (Bill Number: House Bill 680, Feb. 17, 1993).

In June, 1993, this Court issued *Harper v. Virginia Department of Taxation*, 509 U.S. 86 (1993), and held that the doctrine of selective prospectivity is inapplicable in the context of state tax claims based on violations of federal law, including the U.S. Constitution. *Harper* requires states to afford all taxpayers "meaningful backward-looking" relief to remedy the effects of state tax provisions that violate federal law.

Recognizing that its principal reason for refusing to pay the refunds had been eliminated by *Harper*, in the summer of 1993 the Department informed Respondents that it had abandoned its "prospective only" position and that, instead, it was going to rely upon a new theory (which would allow it to keep about 75% of all known refund claims) -- allow "Detroit Formula" factor representation for foreign dividends paid to separate entity filers.

> administered in a constitutional manner prior to legislative action, the Department will allow an additional deduction for certain foreign dividend[s]. . . .

1992 New Mexico Instructions for Corporate Income and Franchise Taxes, Form CIT-1, at 3.

B. The Proceedings Below

1. The Administrative Hearings

Conoco's and Intel's timely filed administrative protests were heard before the Department's same internal hearing officer at separate formal administrative hearings. The Department first presented its "fairer apportionment eliminates facial discrimination" argument to its internal hearing officer during Conoco's formal administrative hearing. It argued that granting factor representation with respect to foreign dividends, while excluding domestic dividends entirely from the apportionable base, remedied the discrimination found in *Kraft*. At approximately the same time, the Department promulgated a proposed regulation, UDI 19:10, that adopted the Detroit Formula and granted factor representation to separate entity filers.

The Department's internal hearing officer acknowledged that New Mexico's corporate income tax scheme as it pertains to separate entity filers "is indistinguishable in any material or meaningful way from the Iowa corporate income tax scheme found by the United States Supreme Court in *Kraft General Foods, Inc. v. Iowa Department of Revenue* to facially discriminate against foreign commerce in violation of the Commerce Clause of the United States Constitution." (App. D, at App. 90, Finding of Fact No. 86.) The Department's internal hearing officer also concluded as a matter of law that "[a]s applied to Conoco . . . New Mexico's corporate income tax scheme facially discriminates against Conoco's foreign source dividend income in contravention of the Foreign Commerce Clause of the United States Constitution." (App. D, at App. 121, Conclusion of Law No. 4.)

The internal hearing officer also ruled that deemed foreign dividends (*e.g.*, Subpart F income) must be treated identically to actual foreign dividends. In addition, the internal hearing officer held that, even if dividend taxation pursuant to New Mexico's combined or consolidated reporting methods did not suffer from the constitutional infirmities that plagued the State's separate entity method, Conoco had elected to report

using the separate entity method and was entitled to have that method applied to it in a constitutional manner.

The Department's internal hearing officer then ruled that the Detroit Formula provided an adequate remedy to redress the ill effects of the unconstitutional discrimination that Conoco had incurred. This was so despite the fact that (A) use of the Detroit Formula had been shown in this case merely to reduce slightly, but not eliminate, the unconstitutional discrimination that the internal hearing officer found to exist (57% to 93% of Conoco's foreign dividends were subject to New Mexico tax, not 100%), and (B) the Department had *no* examples of a case where discrimination was cured. Notwithstanding these facts, the internal hearing officer affirmed the Department's denial of Conoco's refund claims.

2. The Appellate Hearings

Conoco appealed its case to the New Mexico Court of Appeals. Shortly thereafter, two things of importance occurred. First, on March 17, 1994, the Department finalized its Detroit Formula regulation, UDI 19:10. The regulation was adopted with a retroactive date of January 1, 1988. That date is the beginning of the period for which both Conoco and Intel claimed refunds. According to a study conducted by the Department, the regulation would permit the Department to retain approximately 75% of refund claims resulting from its discriminatory inclusion of foreign dividends.

Second, Intel's case was heard before the Department's same internal hearing officer. The internal hearing officer entered a Decision and Order that is not materially different from the Decision and Order that he had entered in Conoco's case.[4]

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[4] The Decision and Order of the Department's internal hearing officer similarly found that, as applied to Intel, the New Mexico tax scheme facially discriminated against Intel's foreign source dividends in violation of the Foreign Commerce Clause. (App. E, at App. 165, Conclusion of Law No. 4.)

In the Spring of 1995, a three-judge panel of the New Mexico Court of Appeals entered a 2-1 decision in *Conoco*. The majority held that the adjustments to the apportionment formula mandated by the Department's new, retroactive Detroit Formula regulation created "comparability" between apportionment of foreign dividend income and exclusion of domestic dividend income. That was so, the court held, even though the regulation was not adopted until after the case had been tried and was pending on appeal. Judge Thomas Donnelly dissented, concluding that the retroactive Detroit Formula regulation did not correct the problem of Commerce Clause discrimination.

Conoco then filed a petition for certiorari with the New Mexico Supreme Court asking for its review of the Court of Appeals' decision.

The Court of Appeals decision involving Intel was announced shortly after Conoco filed its petition. The three-judge panel in *Intel* ruled that it was bound by the other panel's decision in *Conoco*, but noted that it questioned the decision of the majority and urged review by the New Mexico Supreme Court. Judge Donnelly was also on the *Intel* panel and entered a dissenting opinion similar to the one he had issued in *Conoco*. Intel then filed a petition for certiorari with the New Mexico Supreme Court asking for review of the Court of Appeals' decision in its case.

3. The New Mexico Supreme Court's Decision

In July, 1995, the New Mexico Supreme Court granted certiorari and agreed to hear both cases. On November 26, 1996, a three-judge panel of the court announced its decision that New Mexico's scheme of taxing foreign dividend income in the context of separate entity reporting was an unconstitutional violation of the Commerce Clause, applying *Kraft*. It further held that the Department's Detroit Formula regulation did not save the tax scheme. The court was unequivocal that *Kraft* and other U.S. Supreme Court cases mandate that protected forms of commerce be treated equally and not merely comparably, especially when theoretical comparability

resulted in foreign dividend income being included in the tax base and subject to taxation.

The court noted that the Detroit Formula "does not eliminate dividends paid by foreign subsidiaries from the tax base in every case. In particular, it did not do so in these cases." (App. K, at App. 191, ¶15.) The court continued:

> The Detroit formula does not remove all of the dividends paid by foreign subsidiaries from the tax bases of these Taxpayers. It fails to neutralize the discriminatory effect of the separate corporate entity method for taxpayers with foreign dividend income . . . .

(App. K, at App. 192, ¶17.)

The court also rejected the Department's argument that Conoco and Intel were not entitled to relief on the basis that any discrimination to foreign commerce was a result of their decisions to utilize separate entity filing over the other filing options. "We agree with both the Court of Appeals and the hearing officer and find that the presence of other reporting options is not relevant to the Taxpayers' claim." (App. K, at App. 199, ¶24.)

Shortly after the New Mexico Supreme Court issued its decision, the Department filed a Motion for Reconsideration in which it sought, *inter alia*, a remand to its internal hearing officer. On January 23, 1997, the New Mexico Supreme Court denied the Department's motion, withdrew its previous panel opinion and issued a new, unanimous, 4-0 opinion of the court in Conoco's and Intel's favor.

As part of its request for reconsideration, the Department had asked the court to provide it with another opportunity to avoid paying refunds. In denying the Department's motion, the New Mexico Supreme Court stated:

> Serial litigation of multiple efforts to craft a remedy for specific taxpayers would be an affront to judicial economy and the principle of finality.

(App. A, at App. 20, ¶25.)

REASONS FOR DENYING THE WRIT

A.

THE DECISION OF THE NEW MEXICO SUPREME COURT IS OF LIMITED APPLICABILITY OUTSIDE OF NEW MEXICO

While the instant matter is of great importance to both Conoco and Intel, the decision of the New Mexico Supreme Court has limited applicability outside of New Mexico. Even before this Court issued its decision in *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*, 505 U.S. 71 (1992), many states that used the definition of federal taxable income in computing a corporation's state tax liability made adjustments to avoid the discriminatory treatment of dividends from foreign subsidiaries. *Kraft*, 505 U.S. at 81 and n. 24 (referring to pages in the appendix to the petition for certiorari which list the many states that either exclude all dividends or that tax all dividends equally).

Moreover, of the states that did discriminate against dividends from foreign commerce prior to *Kraft*, several have amended their practice so as to treat dividends from foreign commerce equally with dividends from domestic commerce. For example, Iowa now allows the same deduction for dividends flowing from foreign commerce as it does for dividends flowing from domestic commerce (Policy Statement on *Kraft* Decision, [1991-1994 Transfer Binder] Iowa St. Tax Rep. (CCH) ¶ 200-775 (Iowa Dep't of Revenue & Fin. Dec. 14, 1992); Pennsylvania excludes dividends from both domestic and foreign subsidiaries from its tax base (72 Pa. Stat. § 7401(3)1.(b) (1996)); Rhode Island similarly excludes both forms of dividends from the tax base (*Dart Indus., Inc. v. Clark*, 657 A.2d 1062 (R.I. 1995) and Business Corporation Tax Return Form RI-1120, Schedule B); and South Carolina now excludes both types of dividends from its tax base (Revenue Ruling #92-13, S.C. St. Tax Rep. (CCH) ¶ 300-073 (S.C. Tax Comm'n Dec. 3, 1992)).

Thus, the Department's petition for certiorari should be denied because the decision of the New Mexico Supreme Court is not of a sufficient enough magnitude to warrant review. If the New Mexico Supreme Court's decision affected even several other states, it is likely that at least one of those states would have filed an *amicus curiae* brief in support of the Department. The failure, to date, of even a single state, or organization of states (such as the Multistate Tax Commission or Federation of Tax Administrators), or the Federal Government to file such a brief illustrates the limited applicability that the New Mexico Supreme Court decision has outside of New Mexico.

Moreover, that no other state has, to date, filed an *amicus curiae* brief in support of Petitioner similarly belies Petitioner's assertion that this case "involves an attempt to resolve the 'foreign dividend wars' which have raged across the state tax world for so many years." (Petition at 13.) In reality, this case has nothing to do with the so-called "foreign dividend wars." It is merely an attempt by a single state to continue its discriminatory tax scheme.

Finally, the decisions in *In re Morton Thiokol, Inc.*, 254 Kan. 23, 864 P.2d 1175 (1993), and *E.I. du Pont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82 (Me. 1996), are irrelevant to the instant matters. Each of those cases involved the applicability of *Krafi* to corporations that filed combined returns. The instant case, however, involves corporations that, like *Krafi*, filed on a separate entity basis. Thus, further review of separate entity filings would not address the issues raised in *Morton Thiokol* or *E.I. du Pont*.

As the foregoing demonstrates, the decision of the New Mexico Supreme Court is of limited applicability outside of New Mexico. The decision is not worthy of this Court's limited resources. The petition for certiorari should therefore be denied.

B.

THE DECISION OF THE NEW MEXICO SUPREME COURT CORRECTLY APPLIES SETTLED PRINCIPLES OF CONSTITUTIONAL LAW AND DOES NOT MERIT REVIEW BY THIS COURT

The tax scheme at issue in *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*, 505 U.S. 71 (1992), is identical in all relevant respects to the New Mexico tax scheme. Both tax schemes include in the tax base dividends from foreign commerce, but exclude from the tax base dividends from domestic commerce. In light of this identity, it is indisputable that the New Mexico statute is as constitutionally infirm as the Iowa statute. Both schemes discriminate on their face against foreign commerce and both schemes therefore violate the Foreign Commerce Clause.

The Department does not dispute the foregoing. Indeed, following the decision in *Kraft*, the Department conceded that "*Kraft v. Iowa* makes it clear that the New Mexico 'separate entity' option is unconstitutional as written." Bill Analysis and Fiscal Impact Report (Bill Number: House Bill 680, Feb. 17, 1993).

In a transparent attempt to avoid its constitutional obligation to provide equitable treatment of foreign and domestic dividends, the Department adopted its retroactive Detroit Formula regulation (UDI Reg. 19:10). The Department now relies upon this regulation to defend its disparate treatment of foreign and domestic dividends on theoretical grounds while continuing to tax the former more heavily than the latter. As the New Mexico Supreme Court explicitly found, however, "*Kraft* clearly requires that foreign and domestic commerce be treated equally, and the New Mexico tax scheme fails to do this, even with the Detroit formula." (App. A, at App. 12, ¶15.)

1. The Detroit Formula Fails to Cure the Facial Discrimination in New Mexico's Corporate Income Tax Statute

The Department's Detroit Formula regulation does not create equality between the treatment of dividends from foreign commerce and dividends from domestic commerce. Instead, the regulation is little more than a smoke screen to provide cover for the Department in its continuing attempt to defend its facially discriminatory taxing regime that has been condemned by *Kraft*.

The Detroit Formula regulation does not cure the discrimination embodied in New Mexico's taxing scheme because it fails to provide the same treatment for foreign dividends as for domestic dividends. While dividends from foreign commerce are included in the New Mexico tax base, dividends from domestic commerce are excluded.

The Department's defense of the regulation is predicated on the incorrect premise that a taxing scheme that discriminates on its face against foreign commerce can be remedied by indirect, part-way measures that fail to guarantee equality.

The retroactive "remedy" adopted by the Department is, in practical effect, not a remedy at all. Rather, it is a thinly veiled attempt to retain in the state's coffers 75% of the tax on the foreign dividends that *Kraft* holds the Department may not tax at all.

James O'Neill, Assistant Secretary and Director of Tax Policy for the Department, testified in the Intel case that New Mexico "would retain 75 percent of the amount of refund claim made"[5] if taxpayers' *Kraft*-related refund claims were disposed of by reference to the Department's Detroit Formula regulation, rather than by excluding the foreign dividends

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[5] Transcript, Vol. 1 at 192, lines 20-21 (Mar. 30, 1994).

from the tax base.[6] Consistent with that testimony, the Department stated in a paper it prepared for submission to an interim committee of the New Mexico Legislature entitled *Factor Relief As An Answer To Discrimination Claims Under Kraft General Foods v. Iowa Department of Revenue* that: "As a result of [the 'Detroit Formula' of Factor Adjustment], most taxpayers will receive at least a partial refund, averaging about 25% of what they requested."

Indeed, even the Department's own internal hearing officer was "not convinced that the inclusion of foreign factors under the Detroit formula totally eliminates all foreign based dividend income from the tax base." (App. E, at App. 154.)

It is therefore clear that, despite the Department's assertions to the contrary (Petition at 15-16), the Detroit Formula does not "accomplish[] the same result" as the exclusion of foreign-source dividends from the tax base. If the Detroit Formula truly did accomplish the "same result" (Petition at 16), then the Department would not be retaining "75 percent of the amount of refund claim made."

The Department's alleged remedy fails to satisfy the "strict rule of equality" that governs the adjudication of claims of discrimination under the Commerce Clause. *See, e.g., Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64, 70 (1963) ("[E]quality for the purposes of competition and the flow of commerce," after all, "is measured in dollars and cents, not legal abstractions."); *see also Associated Indus. of Mo. v. Lohman*, 511 U.S. 641, 648 (1994) (quoting *Halliburton*); *cf. Minneapolis Star & Tribune Co. v. Minnesota Comm'r of Revenue*, 460 U.S. 575, 585 (1983) (differential taxation of press forbidden "unless the State asserts a counterbalancing interest of compelling importance that it cannot achieve without differential taxation"). Here, it is clear that Respondents are saddled -- in terms of "dollars and cents" --

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[6] Mr. O'Neill's conclusion was based on an analysis of all *Kraft*-related claims that were pending in the Department.

with an extraordinary tax burden that neither would have borne had their dividends resulted from domestic commerce rather than foreign commerce.

2. The Department Confuses Fair Apportionment with Discrimination

In relying upon its Detroit Formula regulation as an alleged antidote to the discriminatory character of the New Mexico tax base (*i.e.*, inclusion of foreign but not domestic dividends), the Department confuses fair apportionment and discrimination.

In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), this Court articulated a four-prong test to determine whether a state tax violates the Commerce Clause. Under this test, a tax will be sustained if the tax (1) is applied to an activity with a substantial nexus with the taxing state, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, *and* (4) is fairly related to the services provided by the state. *Id.* at 279.

The fair apportionment prong articulated in *Complete Auto* was subsequently refined to require that the tax be both internally consistent (*i.e.*, multiple taxation will not result if every state were to impose an identical tax) and externally consistent (*i.e.*, the state is taxing only that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity being taxed). *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169-70 (1983).

In the area of foreign commerce, this Court has expanded the *Complete Auto* test and required, in addition to the four-prong test, that a tax satisfy two additional requirements:

> first, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from "speaking with one voice when regulating commercial relations with foreign governments."

Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434, 451 (1979). In *Japan Line*, this Court held that a fairly apportioned tax (which also satisfied the other three prongs of *Complete Auto*) violated the Foreign Commerce Clause.

Thus, each of the four prongs articulated in *Complete Auto*, and the additional two prongs articulated in *Japan Line* when foreign commerce is involved, must be satisfied for a state tax to satisfy constitutional muster.

The Department is apparently confused over these separate, independent constitutional requirements. The Department continuously asserts that its Detroit Formula regulation fairly apportions a taxpayer's income. (*E.g.*, Petition at 8-9, 22.) The Department's confusion is illustrated by its comment that the New Mexico Supreme Court "made no attempt to apply the traditional discrimination tests of internal and external consistency put forth by this Court in *Container* and *Armco v. Hardesty*, 467 U.S. 638 (1984)." (Petition at 21, n.8.) As previously discussed, however, internal and external consistency are components of the requirement that a tax be fairly apportioned. They are not part of the separate requirement that a tax not discriminate.[7]

The Department is therefore wrong when it asserts that "[t]he facial discrimination problem identified in *Kraft* and the income distortion problem identified by Justice Stevens in *Mobil* are one and the same." (Petition at 24.) As the foregoing establishes, the two requirements are not "one and the

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[7] In *Armco*, which held that West Virginia's wholesale gross receipts tax discriminated against interstate commerce, this Court stated that its discussion of internal consistency in *Container* pertained to the requirement that a tax be fairly apportioned. *Armco* at 644. The Court further stated that a similar rule applies where there is an allegation that a statute facially discriminates against interstate commerce, since a tax that unfairly apportions income from other states is a form of discrimination against interstate commerce. *Id.* This does not mean, however, that a tax that fairly apportions income does not discriminate against interstate or foreign commerce, nor that the fairly apportioned requirement and the no discrimination requirement are not separate, independent requirements.

same." Each is a separate requirement that a state tax must satisfy if it is to pass constitutional muster.

Thus, the issue in these matters is not the red herring which the Department suggests -- *i.e.*, is income fairly apportioned? Instead, the issue is whether the New Mexico taxing scheme, even with the Detroit Formula regulation, discriminates against foreign commerce. It is clear that it does.

Despite the Department's assertions to the contrary, fair apportionment cannot cure a facially discriminatory statute. As this Court has observed,

> Nothing about the apportionment process releases the State from the constitutional restraints that limit the way in which it exercises its taxing power over the income within its jurisdiction.
>
> . . . "Fairly apportioned" and "nondiscriminatory" are not synonymous terms.

Westinghouse Elec. Corp. v. Tully, 466 U.S. 388, 398-99 (1984).

In *Westinghouse*, New York employed a constitutionally acceptable apportionment formula (the standard three-factor formula). Nevertheless, in holding the state's constitutionally acceptable apportionment scheme could not shield a discriminatory levy from constitutional attack, this Court declared that the state's "fair apportionment" argument

> serves only to obscure the issue in this case. The acceptability of the allocation formula employed by the State of New York is not relevant to the question before us. The fact that New York is attempting to tax only a fairly apportioned percentage of a DISC's accumulated income does not insulate from constitutional challenge the State's method of allowing the DISC export credit.

Id. at 398.

The Department is similarly attempting to obscure the issue. New Mexico has constructed a facially discriminatory, constitutionally defective tax base, by including dividends from foreign commerce while excluding dividends from domestic commerce. The allegedly fair apportionment of this tax base cannot remove this defect in principle and does not remove it in practice.

The New Mexico Supreme Court was not misdirected by the Department's confused assertions. After analyzing the New Mexico tax scheme by applying settled principles of constitutional law, it concluded: "Accordingly, we hold that taxing of dividends from foreign subsidiaries under the separate corporate entity method is unconstitutional, even with the Detroit formula." (App. A, at App. 13, ¶16.)

3. The New Mexico Supreme Court's Decision Is Consistent with This Court's Jurisprudence Concerning Remedies

According to the Department, *McKesson Corporation v. Division of Alcoholic Beverages and Tobacco*, 496 U.S. 18 (1990), which involved Florida's refusal to refund unconstitutional liquor excise taxes, only requires a state to remedy a discriminatory tax scheme by creating "a system which eliminates the discrimination as to the affected class as a whole." (Petition at 20.) The Department makes the incredible assertion that "[w]hether a particular taxpayer pays more or less than it would have paid under the former system is quite beside the point." (Petition at 20.)

The Department is wrong. Whether a particular taxpayer suffers impermissible discrimination is precisely the point. The Department's assertion is entirely inconsistent with this Court's decision in *McKesson*. Under *McKesson*, a state must

> provide a "clear and certain remedy" . . . to ensure that the tax as *actually imposed* on petitioner and its competitors during the contested tax period does not deprive petitioner of tax moneys in a manner that discriminates against interstate commerce.

McKesson, 496 U.S. at 43. This Court in *McKesson* prescribed a clear requirement:

> In order to cure the illegality of the tax as originally imposed, the State must ultimately collect a tax for the contested tax period *that in no respect* impermissibly discriminates against interstate commerce.

McKesson, 496 U.S. at 43, n.27 (emphasis added).

Therefore, to satisfy constitutional requirements, the Department's remedy must eliminate, not merely reduce, the offending discrimination by equalizing the treatment of Respondents' foreign-source and domestic-source dividends. Inasmuch as the Department's Detroit Formula regulation does not eliminate the discrimination suffered by Conoco and Intel, the Department's alleged "remedy" does not, as required by *McKesson*, result in a tax that "in no respect" impermissibly discriminates against foreign commerce.

The Department also incorrectly asserts that the decision of the New Mexico Supreme Court is "in direct conflict" with this Court's decisions in *Fulton Corp. v. Faulkner*, 116 S. Ct. 848 (1996) and *Harper v. Virginia Department of Taxation*, 509 U.S. 86 (1993). (Petition at 20.) The Department then makes the ominous statement that "one cannot assume that it will be ignored by other courts and legislatures as future problems arise." (Petition at 21.)

The Department, however, never explains how this "direct conflict" results. Moreover, the problem with the Department's alleged fears is that its premise is wrong. As previously discussed, the decision of the New Mexico Supreme Court is entirely consistent with this Court's decision in *McKesson*. The decision is also consistent with both *Fulton* and *Harper*.

Furthermore, the decision of the New Mexico Supreme Court adequately and appropriately addressed this issue. The New Mexico Supreme Court stated:

> When a tax is found unconstitutional, the Department may "either award full refunds to those burdened by an unlawful tax or issue some other order that 'create[s] in hindsight a nondiscriminatory scheme.'" *Harper v. Virginia Dep't of Taxation*, 509 U.S. 86, 101, 113 S.Ct. 2510, 2519, 125 L.Ed.2d 74 (1993) (quoting *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 40, 110 S.Ct. 2238, 2252, 110 L.Ed.2d 17 (1990)). *See also Dart*, 657 A.2d at 1067 (requiring under Rhode Island law "a refund when a taxpayer has prepaid a tax and is subsequently successful in challenging the legality of that tax").

(App. A, at App. 19-20, ¶24.) The court then found that "[t]he Department apparently attempted to create a nondiscriminatory scheme with the retroactive application of the Detroit formula, *but this attempt was unsuccessful*." (App. A, at App. 20, ¶25 (emphasis added).)

4. The Department Confuses the Requisite Burden of Proof in Determining Whether Its Alleged Remedy Cures Its Otherwise Facially Discriminatory Tax Scheme

The Department's assertions questioning the burden of proof applied by the New Mexico Supreme Court demonstrate another area of confusion suffered by the Department. The Department is apparently asserting that for Respondents to be successful in their cases, they must demonstrate that the Department's alleged remedy (*i.e.*, its Detroit Formula regulation) is valid under no set of circumstances. (Petition at 18-20.)

The Department's assertion, however, confuses the burden of proof necessary to demonstrate that a statutory scheme is facially discriminatory -- a burden which has clearly been met in light of *Kraft* and the Department's public concessions -- and the burden of proof with respect to *remedies* necessary to cure a facially discriminatory tax scheme.

Nothing in this Court's decision in *McKesson Corporation v. Division of Alcoholic Beverages and Tobacco*, 496 U.S. 18 (1990), even remotely suggests that a taxpayer bears the burden of proving that a proposed *remedy* is facially discriminatory (*i.e.*, that the remedy would be valid under "no set of circumstances"). To the contrary, *McKesson* requires that the remedy be one which "in no respect" discriminates against interstate (and foreign) commerce. *McKesson*, 496 U.S. at 43, n.27. Thus, the Department's assertions are without merit and further highlight its confusion.

As the New Mexico Supreme Court correctly held: "we find that the Taxpayers did not have the burden of proving that the New Mexico tax scheme, which discriminated against them individually, would discriminate against every conceivable taxpayer." (App. A, at App. 17-18, ¶22.)

5. The Department's Assertions Concerning Subpart F Income Attempts to Misdirect the Analysis Away from Its Unconstitutional Tax Scheme

The Department makes subtle assertions that Conoco's and Intel's use of the separate entity reporting method in conjunction with their receipt of Subpart F income from certain non-U.S. subsidiaries constitutes a purported "manipulation" of their income earned in New Mexico (Petition at 8-9). This is nothing more than an attempt by the Department to divert attention from the issue of discrimination, and may be readily disposed of. First, the Department has already stipulated that Subpart F foreign dividend income is to be afforded the same treatment as Respondents' other foreign dividend income. (*E.g.*, App. B, at App. 23 n.1.) Thus, the Department's assertions could be viewed as an artful attempt to gloss over the real issue.

Moreover, the Department does not explain adequately why its "manipulation" argument is in any way relevant to the actual issue of discrimination against dividends from foreign commerce. The Department has not heretofore objected to the exclusion of dividends from *domestic* commerce due to the

"manipulation" of earnings, even though the Department likely has similar concerns with respect to the income of U.S. subsidiaries that are not New Mexico taxpayers. Moreover, it should be noted that the Department has identified no actual "manipulation" by either Conoco or Intel. Indeed, the record contains ample evidence demonstrating that each company had various business reasons for operating through foreign subsidiaries.

Conoco's and Intel's decisions to operate foreign investments through non-U.S. subsidiaries and to use a separate entity filing method available to all taxpayers is not a "manipulation" of its earnings as suggested by the Department. Rather, it represents a valid business decision by each company that is predicated upon a filing method afforded to taxpayers by the New Mexico Legislature.

The Department's assertions concerning Subpart F income are therefore merely another attempt to direct the focus away from its unconstitutional tax scheme.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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